Economic Commentary

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BANK OF CANADA TO RAISE INTEREST RATES TOMORROW

In its regularly scheduled rate setting meeting tomorrow the Bank of Canada is likely to raise its benchmark overnight financing rate by a quarter of a point to 3.25%.

A survey of 20 analysts by MMS International last week showed them evenly divided with 10 expecting a rate increase. Another survey of 13 economists surveyed by Dow Jones Newswire found that 9 out of 13 expect an increase. Financial futures on Friday have been factoring a 75% chance of a rate increase. Currency markets also seem to be pricing a rise in Canadian interest rates given the loonie's recent three-year high of 68.8 cents, up 8.8% so far this year.

My expectation is that the central bank will raise interest rates by 1/4 of a point tomorrow. There are good reasons for it to do so. 1) Headline inflation at 4.6% demands action; 2) The Governor of the Bank has been stating loudly and clearly that interest rates will go up in a timely manner, because he needs to reduce the monetary stimulus that has been in the pipeline for some time now. 3) a great deal of the "geopolitical uncertainty" hanging over the horizon has dissipated now that Saddam Hussein's army has collapsed without serious international complications, so there is less of a need for a risk premium. 4) the recent rise in the value of the Canadian dollar to 68.8 cents US needs to be consolidated with a further rise in the spread with US interest rates. Since a higher dollar serves to dampen inflation (by lowering import prices and reducing foreign demand for Canadian goods), keeping the loonie high helps bring inflation down. The more it helps lower inflation, the less the need over the next few months to raise Canadian interest rates higher. According to one analyst, the recent 8.8% rise in the value of the Canadian dollar is the equivalent to a 275 basis point rise in short-term interest rates.

The central bank meets again on June 3rd. At that point I envisage another quarter point hike to 3.5% with another possible hike sometime in the fall. If the recent and current rate hiking action combined with the rise in the Canadian dollar do the trick and help lower inflation, the central bank might not have to raise rates any more this year if the North American and global economy's performance remains sluggish this year as the IMF and most analysts anticipate. Then again, if the Fed cuts interest rates on May 6th to stimulate the US recovery, the widening of the gap between Canadian and US rates will further reduce the odds of an extra quarter point rise in the fall.

In short, I doubt that the central bank will have to raise interest rates as much as it believes it needs to at this time because of falling inflation -now that oil facilities in Iraq have been secured and the price has already come down- and because of a soft economy in the USA, Europe and Japan. Too dramatic a rate hike, on the other hand, risks undermining consumer spending which has been the only force propelling the economy the last two years. Since consumer debt-to-personal disposable income exceeds 100% in the mature industrial world, raising rates dramatically may cause a crash in real estate prices, pull the rug out of the new housing construction market and induce households to retrench spending in order to service their high debt loads.

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